FILED
U.S. Bankruptcy Appellate Panel of the Tenth Circuit

January 15, 1999

Barbara A. Schermerhorn Clerk

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE TENTH CIRCUIT

IN RE THOMAS FROSS and MELINDA S. FROSS, Debtors.	BAP No. KS-98-030
MJPB, INC., Appellant, v. THOMAS FROSS and MELINDA S. FROSS, Appellees.	Bankr. No. 94-21906 Chapter 11 ORDER AND JUDGMENT*

Appeal from the United States Bankruptcy Court
for the District of Kansas

Before BOHANON, BOULDEN, and CORNISH, Bankruptcy Judges.

BOULDEN, Bankruptcy Judge.

The issue presented in this case is whether the Chapter 11 debtors' ownership interest in exempt property is an interest that is "senior" to a class of unsecured creditors' claims that voted against the debtors' plan. If the bankruptcy court is correct, and such an ownership interest is senior to the interest of unsecured creditors, the debtors' retention of the exempt property under their Chapter 11 plan is not a violation of the absolute priority rule

* This order and judgment has no precedential value and may not be cited, except for the purposes of establishing the doctrines of law of the case, res judicata, or collateral estoppel. 10th Cir. BAP L.R. 8010-2.

provided by 11 U.S.C. § 1129(b)(2)(B)(ii),[1] and the debtors' Chapter 11 plan is fair and equitable and may be confirmed. For the reasons set forth herein, we reverse the bankruptcy court, concluding that such an ownership interest is junior to the claims of unsecured creditors, and therefore the debtors' plan cannot be confirmed over the dissenting unsecured class.

Background

The facts are undisputed. The primary asset of Thomas and Melinda S. Fross (Debtors) is their home, valued at $40,000. When the Debtors filed a petition under Chapter 11 on October 18, 1994, they claimed their home and certain personal property as exempt under Kansas law. No party objected to their claimed exemptions. The home is encumbered by a fully secured first mortgage held by Federal Home Loan Mortgage Corporation (FHLMC). MJPB, Inc. (MJPB), the Appellant herein, holds a second mortgage against the home with a balance of approximately $56,317.

The Debtors' Plan of Reorganization (Plan) calls for the bifurcation of MJPB's claim (Class 3)[2] into an allowed secured claim of approximately $18,983 to be paid over twenty years at nine and one-half percent interest. The remaining $37,334 balance of MJPB's claim is treated as a general unsecured claim. The Plan proposes that unsecured creditors (Class 5) be paid ten percent of their claims over ten years at twelve percent interest. The Plan does not contain a class of interests, but provides that the Debtors will retain their property and assets, subject to the security interests of the holders of secured claims. The payments under the Plan are to be funded from the Debtors' future income. Property not required to carry out the Plan may be sold or returned to secured

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[1] Future references are to Title 11, United States Code, unless otherwise noted.

[2] Class 3 includes both MJPB's secured and unsecured claim. The Plan contains a cross reference to Class 5, which is the class of unsecured claims.

creditors, with any surplus applied toward current operating expenses.

FHLMC voted to accept the Plan. MJPB, having failed to elect treatment under § 1111(b), voted the unsecured deficiency portion of its Class 3 claim to reject the Plan. Class 5 also voted against the Plan. MJPB objected to the confirmation of the Plan, arguing that it violated the absolute priority rule as set forth in § 1129(b)(2)(B)(ii) because the Debtors were retaining their exempt property, including their home.

The bankruptcy court issued a Memorandum Opinion and Judgment overruling MJPB's objection to the confirmation of the Plan. *In re Fross*, 220 B.R. 405 (Bankr. D. Kan. 1998). *Fross* acknowledged that the Code distinguishes between property of the debtor and property of the estate, but did not discuss that "of the debtor" or "of the estate" does not modify "property" as the term is used in § 1129(b)(2)(B)(ii). Instead, *Fross* concluded that the Debtors' exempt property was no longer property of the estate, and that the Plan had not waived the Debtors' right to keep their exempt property outside the estate. Since unsecured creditors lack any right to expect payment of their claims from exempt homestead property under Kansas law, *Fross* concluded that the Debtors' ownership interest in their exempt property was senior to the interests of unsecured creditors. *Id*. at 410. In so holding, *Fross* explained:

> If the Frosses' residence were property of the estate, their interest in it would be junior to the claims of unsecured creditors since applicable law would entitle those creditors to payment from the value of the residence. But since the Frosses' interest in their residence is outside the bankruptcy estate, and unsecured creditors cannot reach its value, their interest in the residence cannot be fairly characterized as junior to the claims of unsecured creditors.

Id. This appeal followed.

Appellate Jurisdiction

This Court, with the consent of the parties, has jurisdiction to hear timely-filed appeals from "final judgments, orders, and decrees" of bankruptcy courts

within the Tenth Circuit. 28 U.S.C. § 158(a)(1), (b)(1), and (c)(1); Fed. R. Bankr. P. 8002. Upon leave of Court, the Court also has jurisdiction to hear appeals from interlocutory orders. 28 U.S.C. § 158(a)(3), (b)(1), and (c)(1).

MJPB timely filed a notice of appeal from the Judgment, and the parties have consented to this Court's jurisdiction in that they have not opted to have the appeal heard by the United States District Court for the District of Kansas. *Id*. at § 158(c); Fed. R. Bankr. P. 8001; 10th Cir. BAP L.R. 8001-1. The Judgment, however, is not "final" as required under § 158(a)(1) because it did not "end the litigation on the merits . . . ." *Van Cauwenberghe v. Biard*, 486 U.S. 517, 521-22 (1988). The Judgment overruling MJPB's objection stated: "[T]he reorganization plan is confirmable under § 1129(b)(2)(B), *provided* the debtors can show the Court that they have met all other requirements of § 1129(a); excluding, of course, § 1129(a)(8)." Aplee. App. at 15. (emphasis added). When the notice of appeal was filed, an order confirming the Plan had not been entered, and further proceedings related to the confirmation of the Plan were necessary. As a result, this Court issued an Order to Show Cause Why Appeal Should Not be Considered for Dismissal as Interlocutory, and in response, both parties filed motions for leave to appeal under 28 U.S.C. § 158(a)(3).

Leave to appeal an interlocutory order under 28 U.S.C. § 158(a)(3) is reserved for cases of exceptional circumstances. The order appealed must involve "a controlling question of law as to which there is substantial ground for difference of opinion, and the immediate resolution of the order may materially advance the ultimate termination of the litigation." *Personette v. Kennedy (In re Midgard Corp.)*, 204 B.R. 764, 769 (10th Cir. BAP 1997).

The parties informed the Court at oral argument that at the time of the hearing, the bankruptcy court had not entered an order confirming the Plan, and that such an order would not be entered pending resolution of this appeal. The

parties also agreed that all issues related to the confirmation of the Plan, including feasibility, claims classification, and balloting, have been resolved. The issue before this Court is the only bar to confirmation. Based on this information and the analysis below, we conclude this appeal involves a controlling issue of law as to which there is a substantial difference of opinion, and the resolution of the narrow issue before us will materially advance the termination of this litigation. Therefore we grant the parties' motions for leave to appeal, and allow the appeal to proceed.

Discussion

Fross concluded the Debtors' interest in their exempt property was senior to the unsecured creditors' class because the Debtors' exempt property was not property of the estate. Therefore the Debtors' plan could be confirmed over the dissenting class of unsecured creditors because it did not violate the absolute priority rule. *Fross*, 220 B.R. at 408-10. We conclude that this ruling fails to consider the plain language of § 1129(b)(2)(B)(ii) and requires reversal. As did *Fross*, we begin with the language of the statute. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240-41 (1989). The standard for determining if the treatment of a class of unsecured creditors is fair and equitable (the absolute priority rule) is set forth in § 1129(b) of the Code as follows:

> (1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.
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> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
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> . . . .
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> (B) With respect to a class of unsecured claims—
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> (i) the plan provides that each holder of a claim of such

> class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
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> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. § 1129(b)(1), (b)(2)(B)(ii). In its most general sense, "the absolute priority rule 'provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan.'" *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) (alteration in original) (quoting lower court decision); *accord Unruh v. Rushville State Bank*, 987 F.2d 1506, 1508 (10th Cir. 1993). "Under current law, no Chapter 11 reorganization plan can be confirmed over the creditors' legitimate objections . . . if it fails to comply with the absolute priority rule." *Ahlers*, 485 U.S. at 202.

The absolute priority rule is more easily applied to corporate debtors, which are not entitled to claim property as exempt, than to individual debtors. However, we cannot conclude that Congress was unaware of the unique issues related to individual Chapter 11 debtors, including the impact of the absolute priority rule on exempt property, when § 1129(b)(2)(B)(ii) was drafted because the application of the absolute priority rule to individual Chapter 11 debtors was intentional.

Prior to the enactment of the Code, the Act of 1938 (Chandler Act) contained four Chapters specifically related to reorganization: Chapter X, reorganization of public companies; Chapter XI, arrangements and compositions of the unsecured debt of closely-held corporations, partnerships and individuals (which, in the case of corporations, expressly prohibited dealing with the rights of shareholders); Chapter XII, real property arrangements by persons other than corporation; and Chapter XIII, wage earners' plans. As originally enacted, all of

these Chapters required that a reorganization plan be "fair and equitable." *See* Bankruptcy Act §§ 77B(f), 366(3), 472(3), & 656(a), 11 U.S.C. §§ 207(f), 766(3), 872(3), & 1056(a) (1951) (repealed).

Under the Act, the words "fair and equitable" were "'words of art'" which had a well-established meaning in the context of corporate reorganizations. *SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 610 (1965) (quoting *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 452 (1940)). In particular, the phrase signified that a plan or arrangement was to conform to the rule established in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), an equity receivership reorganization case decided prior to the enactment of the Chandler Act, which was held to apply to Chapter X in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). *See Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*, 317 U.S. 78, 85-86 (1942); *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 527 (1941); *United States Realty*, 310 U.S. at 452.[3] The rule established in *Northern Pacific* was that "unsecured creditors are entitled to priority over stockholders to the full extent of their debts and that any scaling down of the claims of creditors without some fair compensating advantage to them which is prior to the rights of stockholders is inadmissable." *American Trailer*, 379 U.S. at 610 (quoting *United States Realty*, 310 U.S. at 452); 9 *Collier on Bankruptcy* Ch. XI ¶ 9.18[2.1] & Ch. XII ¶ 9.07[4] at 296 & 1142 (14th ed. 1977) (citing cases); *see Ahlers*, 485 U.S. at 202 (hereinafter the

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[3] In *Case*, 308 U.S. at 115, the Court recognized that:

> In equity reorganization law the term "fair and equitable" included, inter alia, the rules of law enunciated by this Court in the familiar cases of *Chicago, R.I.&P. Railroad Co. v Howard*, 7 Wall. 392, 19 L.Ed. 117; *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co.*, 174 U.S. 674, 19 S.Ct. 827, 43 L.Ed. 1130; *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931; *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028. These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans.

Common-Law Absolute Priority Rule).

Since prior Chapters XI-XIII contained provisions like that in Chapter X requiring that a reorganization arrangement or plan be "fair and equitable," it seemed clear that the Common-Law Absolute Priority Rule would be applied in cases filed under these Chapters as well, even those involving individual debtors. *See, e.g.*, *United States Realty*, 310 U.S. at 452 (Common-Law Absolute Priority Rule applies under Chapter XI); 9 *Collier on Bankruptcy* Ch. XI ¶ 9.18[2] at 301 & Ch. XII ¶ 9.07[4] at 1143 (14th ed. 1977) (recognizing this point). However, application of the Common-Law Absolute Priority Rule to individual cases under Chapters XI-XIII, and even corporate cases under Chapter XI where the rights of shareholders could not be impacted, was believed to frustrate the intent of those Chapters. *See, e.g.*, *United States Realty*, 310 U.S. at 453; 9 *Collier on Bankruptcy*, Ch. XI ¶ 9.18[2.1] at 301-302, Ch. XII ¶ 9.07[4] at 1143 (14th ed. 1977).

As a result, prior Chapters XI-XIII were amended in 1952 to delete the phrase "fair and equitable" from the sections related to confirmation of a plan or arrangement. Provisions were also added to each Chapter specifically stating that the Common-Law Absolute Priority Rule did not apply. Pub. Law 456 (S. 2234), 82nd Cong., 2d Sess. §§ 35, 43, & 50 (1952); Bankruptcy Act §§ 366, 472, & 656(a), 11 U.S.C. §§ 766, 872, & 1056(a) (1977) (repealed).[4] The legislative history to the 1952 amendment stated:

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[4] In Chapter XI, this provision stated: "Confirmation of an arrangement shall not be refused solely because the interest of a debtor, or if the debtor is a corporation, the interests of its stockholders or members will be preserved under the arrangement." Bankruptcy Act § 366, 11 U.S.C. § 766 (1977) (repealed). *See also* Chapter XII, Bankruptcy Act § 472, 11 U.S.C. § 872 (1977) (repealed) ("Confirmation of an arrangement shall not be refused solely because the interest of a debtor will be preserved under the arrangement."); Chapter XIII, Bankruptcy Act § 656(a), 11 U.S.C. § 1056(a) (1977) (repealed) ("Confirmation of a plan shall not be refused solely because the interest of a debtor will be preserved under the plan.").

> [T]he fair and equitable rule, as interpreted in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), and *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U.S. 106 (1939), cannot realistically be applied in a chapter XI, XII, or XIII proceeding. Were it so applied, no individual debtor and, under chapter XI, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payment of the claims of all creditors in full.
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> Chapter XI has replaced the old composition procedure under former section 12 of the Bankruptcy Act, where the fair and equitable rule did not apply. Nor is it practicable or realistic to apply the rule in a proceeding under chapter XI, XII, or XIII.
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> The proposed amendment is designed to remove the fair and equitable provision, and by the paragraph added to each of the amended sections (366, 472 and 656a of the Act) it is made clear that the rule of the *Boyd* and *Los Angeles* cases shall not be operative under those three chapters.

H.R. Rep. No. 2320, 82nd Cong., 2d Sess. 21, *reprinted in* 1952 U.S. Code Cong. & Admin. News (June 26, 1952).

The Act was amended in 1978, resulting in the current Code. Under Chapter 11, available to individual debtors, a reorganization plan cannot be confirmed over a dissenting unsecured class unless it is, among other things, "fair and equitable." § 1129(b)(1). Unlike the Act, the phase "fair and equitable" is statutorily defined in § 1129(b)(2) of the Code. Despite the prior history of preventing the application of a "fair and equitable" standard, or the Common-Law Absolute Priority Rule in reorganizations involving individuals, Chapter 11 of the Code makes no such exception. This history compels the conclusion that Congress intended the absolute priority rule as stated in § 1129(b)(2)(B)(ii) to apply equally and in the same manner to individual debtors as it does to nonindividual debtors. *Bonner Mall Partnership v. U.S. Mortgage Co. (In re Bonner Mall Partnership),* 2 F.3d 899, 912 (9th Cir. 1993) ("Once it has been shown that Congress was aware of a pre-Code practice, the remaining inquiry under *Dewsnup* and *Davenport* is whether it has made clear its intent to change that practice."). Congress was presumed to know of the former law exempting

individuals from the "fair and equitable" test under the Act, and it did not expressly adopt that exception in the Code. *See Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (recognizing that when the Code was enacted, Congress was presumed to know of former practices, and while the courts are reluctant to amend former practices, especially where the Code's legislative history is silent, the courts are required to follow unambiguous provisions of the Code); *American Trailer*, 379 U.S. at 611 (if Congress had intended for the "fair and equitable" standard applicable under Chapter X of the Act to apply to Chapter XI cases which involve public investors, it would have so stated).

We trace this statutory history to emphasize that the application of the absolute priority rule to individuals was not inadvertent, and that the choice of language in § 1129(b)(2) is intentional and not a mere scrivener's error. Thus, we must give effect, if possible, to every clause and word of a statute. *Negonsott v. Samuels*, 507 U.S. 99, 106 (1993) (quoting *Moskal v. United States*, 498 U.S. 103, 109-110 (1990)). With this historical perspective, we apply the facts of the Debtors' case to the language in § 1129(b)(2)(B)(ii).

The Debtors as the Holders of an Interest

For § 1129(b)(2)(B)(ii) to apply, the Debtors must be "the holders of *any* . . . interest . . . ." § 1129(b)(2)(B)(ii) (emphasis added). An "interest" for purposes of § 1129(b)(2)(B)(ii) has been broadly defined by the Tenth Circuit in *Unruh*, 987 F.2d at 1508-1509, where the court addressed the issue of whether Chapter 11 debtors in consolidated cases had "an 'interest' in their respective bankruptcy estates on account of which they are receiving or retaining property." *Id*. at 1507. The debtors in *Unruh* were individuals who operated family farms as sole proprietorships and held additional employment aside from their farms. The debtors proposed plans paying a minimal return on unsecured claims, but were to retain their property and manage their assets subject to secured claims until

completion of their plans, and then free of the secured claims thereafter. The unsecured creditors rejected the debtors' plans. The debtors argued their plans should be confirmed over the creditors' dissent because the absolute priority rule did not apply to them inasmuch as they did "not have an 'interest' on account of which they have received 'property' within the meaning of the rule." *Id*. at 1508. In rejecting this argument, the Tenth Circuit stated:

> We understand Appellants to be arguing that when the court makes a determination of whether a sole proprietor has an interest in the bankruptcy estate under the rule, the court must first consider what Congress meant by an "interest" and "property" when they codified the rule. Appellants assert that the legislative history of the rule indicates that the rule was only intended to apply to corporate reorganizations, and that "interest holders" were people considered to have separate legal identities from the entity being reorganized, such as stockholders or partners. Appellants further argue that since a sole proprietor has no separate interest from the proprietorship all property of the proprietor becomes property of the estate upon filing a petition. Thus, only if the value of the estate exceeds the amount of claims against it does the proprietor have a right to the property of the estate. When the estate is insolvent and has no going concern value, the sole proprietor has no "interest" under the rule. . . .
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> We disagree with the approach urged by Appellants. . . . The Supreme Court has . . . held that "[a]bsent a clearly expressed legislative intention to the contrary, [statutory] language must ordinarily be regarded as conclusive." *Consumer Product Safety Commission v. GTE Sylvania*, 447 U.S. 102, 108, 100 S.Ct. 2051, 2056, 64 L.Ed.2d 766. The rule [in § 1129(b)(2)(B)(ii)] on its face is unambiguous. It prohibits a junior interest or claim holder from retaining or receiving property on account of that interest or claim when a dissenting class of unsecured creditors is not paid in full. Although the Bankruptcy Code does not define "interest," commentators hold the view that it is used to refer to holders of ownership interests.
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> > "The Code does not define the term 'interest' but such term is used to subsume the *ownership interest of an individual debtor in his property*, the interest of equity security holders, as defined in section 101, and the interest of general partners in a debtor partnership."
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> 5 COLLIER ON BANKRUPTCY ¶ 1141.01 at 1141-6 n.12 (15th ed. 1992). Because Appellants have a right to the future profits of their farms regardless of insolvency at the time of the petition, we think that Appellants clearly have interests in their estates in the form of equitable ownership interests.

Id. (emphasis added).

Thus, in *Unruh*, the Tenth Circuit made clear that an "interest" includes the

ownership interest of an individual debtor in his or her property. As such, we conclude that an "interest" under § 1129(b)(2)(B)(ii) includes the ability of an individual debtor who is not a sole proprietorship to retain his or her property and realize any future appreciation therein, regardless of the value of such property. *Accord In re East*, 57 B.R. 14, 17-18 (Bankr. M.D. La. 1985) (concluding that the debtor has an "interest" because "the plan contemplates that the Debtor, an individual, will retain ownership of the property; he retains the equity (even if it has negative value) or residual interest in his patrimony"); *In re Tomlin*, 22 B.R. 876, 877 (Bankr. M.D. Ala. 1982) (plan of individual Chapter 11 debtor violated § 1129(b)(2)(B)(ii) because the debtor proposed retaining real and personal property with less than 100% payment to unsecured creditors). Our holding is supported by the plain language of § 1129(b)(2)(B)(ii) which states that it applies to "any . . . interest . . . ." § 1129(b)(2)(B)(ii).

The Debtors' Plan states that "[t]he Chapter 11 Debtors shall retain their property and assets, subject to the security interests of the holders of secured claims, except as otherwise provided in the Plan; provided, however, that upon completion of the Plan, all security interests of the secured creditors shall be released." Plan of Reorganization, p. 12. Since the Debtors are retaining an interest in their property under the Plan,[5] they have an "interest" for purposes of § 1129(b)(2)(B)(ii), regardless of the value of that property.

Are the Debtors' Retaining Property Within the Meaning of the Code?

Section 1129(b)(2)(B)(ii) provides that the junior claim or interest holder may not receive or retain "any property." As acknowledged by the bankruptcy court, the Code is replete with references to either property "of the estate" or "of the debtor." *Fross*, 220 B.R. at 409. More to the point, in § 1123 dealing with

[5] The Plan specifically provides that the Debtors will retain their property. We do not address the issue in relation to other theories in which a debtor may retain property otherwise than by virtue of an explicit plan provision.

the contents of a Chapter 11 plan, the Code refers to property "of the estate" no less than four times. *See* § 1123(a)(5)(A), (B), (D); (b)(4). Therefore, we must view the omission of a reference to either property "of the estate" or "of the debtor" in § 1129(b)(2)(B)(ii) as intentional. Likewise, we read the fact that § 1129(b)(2)(B)(ii) does not expressly exclude exempt property to mean that the broad reference to "any property" includes both exempt and nonexempt property. *See In re Kovalchick*, 1995 WL 118171, at * 4 (Bankr. E.D. Pa. 1995) ("Because the Debtors retain their 'interests' as well as the property and assets of the estate, and these interests and the estate include both exempt and nonexempt property, the Plans violate the [absolute priority rule]."); *In re Ashton*, 107 B.R. 670, 674 (Bankr. D.N.D. 1989) ("Section 1129(b)(2)(B)(ii) says that a debtor may not retain any property without qualification. There is no distinction between exempt and non-exempt property."); *In re Yasparro*, 100 B.R. 91, 95 (Bankr. M.D. Fla. 1989) (§ 1129(b)(2)(B)(ii) "makes no distinction between exempt and non-exempt property nor as to value"); *accord In re Johnson*, 101 B.R. 307, 309 (Bankr. M.D. Fla. 1989); *In re James*, 1992 WL 21365, at *6 (Bankr. M.D. Fla. 1992); *In re Big Dry Angus Ranch, Inc.*, 69 B.R. 695, 698 n.3 (Bankr. D. Mont. 1987); *In re Holthoff*, 58 B.R. 216 (Bankr. E.D. Ark. 1985); *East*, 57 B.R. at 17-18; *In re Hendrick*, 45 B.R. 976 (Bankr. M.D. La. 1985); *In re Barr*, 38 B.R. 323 (Bankr. E.D. Mich. 1984); *see also Ahlers*, 485 U.S. at 208 (the meaning of property under § 1129(b)(2)(B)(ii) is "quite broad").

The difficulty with the reasoning in *Fross* is that it excludes the Debtors' retention of their exempt interests from the reach of § 1129(b)(2)(B)(ii) because their interests are "outside the bankruptcy estate." *Fross*, 220 B.R. at 410. Such an interpretation is no different than adding "of the estate" to modify "property" rather than giving "property" the broad interpretation intended. We think it clear that such an interpretation fails to rely upon the plain language of the statute, and

ignores the lengthy history of the absolute priority rule that simply prohibits the Debtors' retention of property, no matter in what form.

Retention of Property "on Account of" the Debtors' Interest

Junior interest holders are not precluded from receiving or retaining property under a Chapter 11 plan, provided the property is not received or retained "on account of" their junior interest. *Bonner Mall*, 2 F.3d at 908-909 (discussing "on account of" in the context of the new value "exception" to the absolute priority rule); *In re Homestead Partners, Ltd.*, 197 B.R. 706, 712-13 (Bankr. N.D. Ga. 1996) (defining "on account of" to simply mean "because"). Here, the Debtors are retaining their exempt property on account of their ownership interest therein. *See In re Drimmel*, 108 B.R. 284, 289-90 (Bankr. D. Kan. 1989), *aff'd*, 135 B.R. 410 (D. Kan. 1991), *aff'd sub nom. Unruh v. Rushville State Bank*, 987 F.2d 1506 (10th Cir. 1993). Indeed, it is their ownership interest in the home that gives the Debtors any exemption rights under § 522(b) and Kansas law at all.[6]

Is the Debtors' Ownership Interest Senior to that of Unsecured Creditors?

Section 1129(b)(2)(B)(ii) requires that the Debtors hold an "interest that is junior to the claims of [the unsecured] class . . . ." 11 U.S.C. § 1129(b)(2)(B)(ii). The bankruptcy court ruled that § 1129(b)(2)(B)(ii) did not apply because the Debtors' interest in their exempt property was not "junior" to the interests of unsecured creditors. *Fross*, 220 B.R. at 410. We disagree with this analysis.

It is generally held that a debtor's ownership interest in property is "junior" to the claims of unsecured creditors. *See In re Knutson*, 40 B.R. 142,

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[6] Recognizing the "on account of" language in this manner arguably excludes the application of § 1129(b)(2)(B)(ii) to a debtor's retention of postpetition earnings from services, which although not property of the estate under § 541(a)(6), may fall under the § 1129(b)(2)(B)(ii) "any property" language. In such a case, an individual debtor is arguably not receiving or retaining the income "on account of" his or her former ownership interest in property.

144 (Bankr. W.D. Wis. 1984); *Tomlin*, 22 B.R. at 877 (citing cases); *see also Drimmel*, 108 B.R. at 287 (recognizing that a sole proprietor's interest in its business "are last in the priority ladder . . . ."). Despite this fact, *Fross* held that the Debtors' interest was not "junior" to unsecured creditors because their property was exempt and, therefore, it was property of the Debtors in which the unsecured creditors had no rights under state law. *Fross*, 220 B.R. at 410. The bankruptcy court's analysis focuses on the Debtors' ownership interest in their exempt property and upon state law. We think the analysis requires a broader approach.[7] As noted above, § 1129(b)(2)(B)(ii) applies to "the holder of *any* . . . interest that is junior to claims of [the unsecured] class." 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added). As such, the Debtors' general ownership interest in assets retained under the Plan makes them the holders of an interest that is junior to that of unsecured creditors. *See Fross*, 220 B.R. at 409 (quoting Plan at p. 12). Further, although we acknowledge that property rights in

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[7] The only case we are aware of that supports the bankruptcy court's conclusion is *In re Egan*, 142 B.R. 730, 733 (Bankr. E.D. Pa. 1992), where the court explained its earlier decision in *In re Harman*, 141 B.R. 878 (Bankr. E.D. Pa. 1992), and expressly stated that exempt property is not within the absolute priority rule. In discussing *Harman*, the court in *Egan* stated:

> In *Harman*, the Debtors' plan proposed their retention of non-exempt property in the amount of $166,000, as well as their exempt property. It is only because of this factor that we became concerned about the application of the absolute priority rule in that case. This is because, if debtors intend to retain only exempt property, then they are merely retaining that which is their absolute right to retain in any event, and they are not, properly speaking, receiving or retaining "any interest that is junior to the interests" of any class of creditors, 11 U.S.C. § 1129(b)(2)(B), including the class of unsecured creditors.
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> The Debtors [in *Egan*] have claimed that all of their property is exempt. No objections to their exemptions claimed were timely filed. Therefore, no objections to those exemptions can now be recognized, and the Debtors' claim of exemptions of all of their property is conclusively established.
>
> Therefore, it appears that no impediment to confirmation of the Debtors' plan presents itself.

Egan, 142 B.R. at 733 (citations omitted). For the reasons set forth above, we decline to adopt the holding in this case.

bankruptcy are interpreted under state law, *Butner v. United States*, 440 U.S. 48, 54 (1979), the requirements related to confirmation of a Chapter 11 plan are matters governed by federal law. Were that not the case, the standards for Chapter 11 plan confirmation would vary from state to state, depending upon the exemption laws applicable in that district.

Application of § 1129(b)(2)(B)(ii) is Consistent with the Underlying Policies of Chapter 11

Ultimately, we must inquire whether the conclusion we have reached is consistent with the structure of the law as a whole and its objective and policy. *See Patterson v. Shumate*, 504 U.S. 753, 763-65 (1992). We find no conflict with other provisions of the Code. *Fross* focused upon § 1123(c),[8] that precludes the involuntary use of a debtor's exempt property in a plan proposed by a creditor. That provision is inapplicable to this Plan proposed by the Debtors. However, by analogy, it is consistent with our conclusion. First, § 1123(c) shows that Congress was aware of the exemption issue for individual debtors, and could have included "of the estate" to modify the word "property" in § 1129(b)(2)(B)(ii) but did not.[9] Second, § 1123(c) allows a debtor to voluntarily commit exempt property to repayment of creditors if it wishes to obtain the advantages of confirmation of a Chapter 11 plan, which contains fewer restrictions than those applicable to Chapter 13 plans. *See, e.g.,* § 1141(d)(1)(A) (discharge effective upon confirmation); § 1322(d) (Chapter 13 plan cannot last longer than five years, whereas the Debtors' Plan proposes repayment over ten

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[8] Section 1123(c) states: "In a case concerning an individual, a plan proposed by an entity other than the debtor may not provide for the use, sale, or lease of property exempted under section 522 of this title, unless the debtor consents to such use, sale, or lease." 11 U.S.C. § 1123(c).

[9] We note that Congress could also have addressed other property of the debtor, such as a debtor's interest in an ERISA qualified plan or in abandoned property, but did not do so. Since the facts in this case do not include such property, we decline to address whether retention of such property would fall within § 1129(b)(2)(B)(ii).

years); § 1101(1) (indicating no mandatory appointment of a trustee in a Chapter 11); § 1325(a)(1) (requiring initial plan payment to be made within forty-five days after filing petition); § 1325(B)(1) (requiring debtor to pay disposable income to plan payments).

We also believe this approach is consistent with § 522(c),[10] which limits the extent to which exempt property is "liable" for the claims of prepetition creditors. The use of the wording "is not liable" in § 522(c) implies that exempt property may not, involuntarily, be used to satisfy claims. However, when a debtor voluntarily seeks reorganization, the Code imposes certain conditions in order to obtain confirmation, and in this case one of the conditions of the ability to confirm a plan over a stripped down[11] bifurcated dissenting unsecured class paid less than the full present value of their claims is that the Debtors shall not retain any exempt property. In a similar context the Eighth Circuit has indicated:

> Including exempt income in disposable income does not make exempt property "liable" to Chapter 13 unsecured creditors. Chapter 13 relief is at the option of the debtor. . . . The disposable income limitation in § 1325(b) simply defines the terms upon which Congress has made the benefits of Chapter 13 available.

Stuart v. Koch (In re Koch), 109 F.3d 1285, 1290 (8th Cir. 1997). If a cramdown was not necessary, because the senior class of unsecured creditors voted for the Debtors' modest repayment Plan, the Debtors could retain their exempt property.

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[10] Section 522(c) states "[U]nless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case . . . ." 11 U.S.C. § 522(c).

[11] Section 1123(b)(5), which was added to the Code under the Bankruptcy Reform Act of 1994, prevents the modification of secured claim holders' rights who are secured only by a security interest in real property that is a debtor's principal residence. This new section does not apply in this case filed prior to October 22, 1994, the effective date of the Act. The Debtors maintain that the subsequent amendment limits the applicability of the legal issue involved in this appeal. We disagree. While the ability to bifurcate undersecured claims secured by an interest in real property that is a debtor's principal residence has been eliminated, the issue regarding § 1129(b)(2)(B)(ii) is applicable to the cramdown of all unsecured creditors, regardless of how their claims came to be unsecured.

See Bonner Mall, 2 F.3d at 914 (§ 1126(c) "permits creditors to waive a priority they possess"). In order to force confirmation, the price to be paid by the Debtors is the absolute priority rule's application to all the property the Debtors propose to retain.

We note that in adopting this interpretation, the Court is not writing the use of exemptions out of individual Chapter 11 debtor cases. The Debtors' exemptions will be considered under the "best interest of creditors" test set forth in § 1129(a)(7), and the Debtors are protected under § 1123(c) in the event that a third party proposes a plan. But, where a debtor intends to avail itself of the protection available under Chapter 11 and pay less than 100% to unsecured creditors, if an unsecured creditor objects to such treatment, the debtor will be required to contribute all of his or her property, exempt or otherwise, to the extent required under § 1129(b)(2)(B)(ii) to obtain plan confirmation.

Conclusion

For the reasons stated above, the Judgment is reversed.